COVERED CALL
TRADING
STRATEGIES FOR
ENHANCED INVESTING
PROFITS
STEVE PLACE

VISIT...

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Covered Call Trading:

Strategies for Smart Investing Profits

By Steven Place

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How to Get the Most Out of This Book

If you're looking for some magic bullet or secret formula that will double your account in only 3 months, then you've picked up the wrong book. If you aren't serious about learning the concepts and frameworks needed and want a robot to do your trading for you, simply ask Amazon for a refund as you won't find what you're looking for here.

But if you are committed to acquiring serious knowledge about options trading and how you can generate a long term edge in the markets, then you are in the right place.

However, you can't just read your way to financial success. Your financial education needs to include books, videos, interactive webinars, and actual experience trading the markets.

That is why this book has **extra bonuses.**

You will receive:

- a covered call spreadsheet to track trades

- further video training about covered calls

- a covered call process map for you to use in your trades

These key resources will help you learn about covered calls and give you the tools needed to become a more successful trader. These are my gift to you for reading this ebook.

Get the bonuses here

http://courses.investingwithoptions.com/covered-call-bonuses/

Why You Need to Read this Book

This book is all about how you can become a better trader through stock options. Specifically, it's about covered calls and how you can make the most from this trading strategy.

I hate finance textbooks. They either go into the hard math behind derivatives, or stick with super high level concepts. In essence, it's very hard to get practical, actionable information from "traditional" finance learning channels.

This book will give you real-world applications about covered calls and related trade strategies, along with potential trade screeners and risk management techniques. That's the extra edge you need, and the edge that this book gives you.

To become a successful trader, it's not about a high win rate or about hitting homeruns.

It's about consistency.

Covered calls are a strategy to reduce risk, enhance returns, and give you an edge in the market. **This strategy will make you more consistent as an options trader and investor.**

The problem with covered calls is that this strategy includes options, which means that there are additional risks. If you understand the risks involved, then you can look for actionable trade ideas.

And aside from trade ideas, you need a sound strategy from picking the right stocks, picking the right options, and knowing how to manage your risk. We will be going over all of that.

I've taught and mentored hundreds of options traders, so I know what novice option traders need when it comes to mastering key options concepts. I also know why you don't even want to consider covered calls.

3 Beliefs That Keep You From Trading Covered Calls

1. A belief that you will double your money every 3 months.

Don't get me wrong, there are ways to make a ton of money using options. Stock options can give you leverage on your capital, and if you are aggressive enough then you can make large returns on your account.

The problem is with higher rewards, you have higher risk. Using leverage means you take on a lot more risk.

Covered calls give you the ability to make higher risk-adjusted returns. It won't double your account, but annual returns well over 20% are feasible given the right market conditions. Of course, returns will never be guaranteed, but that's the same with traditional stock returns as well.

2. A belief that you have to be a perfect market timer.

One of the benefits of getting better risk-adjusted returns is that you don't have to try and nail tops or bottoms. Covered calls allow you to buy a stock and lower your cost basis, so even if the investment starts to go against you, there are ways to adjust the position to reduce your risk.

3. A belief that options are super complex.

This goes back to the "textbook-problem" of traditional finance books. Options are complex if you spend your entire time trying to solve differential equations for options pricing.

But let's leave the heavy math to the college undergrads and the computers. You need to focus on the practical applications of covered calls, and the risks involved. These option risks are known as the greeks, and we'll go over all of that in this book.

Have a Belief In Yourself

Mastering covered call trading will give you a significant edge over the very long term. Having the ability to get higher risk-adjusted returns will set you up as a much more sophisticated investor for years to come.

But this isn't a magic bullet, and it does require hard work and

immersion into the craft of options trading.

My website InvestingWithOptions was started in the middle of a market crash. I didn't know if traders would listen to me as I was just some twenty-something with an engineering degree who learned how to make money with options. I have become what you would call a 5 year overnight success, and I believe that if I can make it, so can you.

The gap is closing between smaller retail traders and the hedge funds of the world. The software you have access to now wasn't available 10 years ago. Investing education has also come by leaps and bounds from the shady infomercials of red/green light trading. If you take advantage of the opportunity now, then you will be set for a more comfortable financial future.

Let's get started.

Contents

Covered Call Trading:

Strategies for Smart Investing Profits

By Steven Place

- How to Get the Most Out of This Book
- Why You Need to Read this Book
- 3 Beliefs That Keep You From Trading Covered Calls
  - Have a Belief In Yourself
- Table of Contents
- Introduction
- Financial Disclaimer
- What is a Covered Call?
  - Risks and Rewards
- Why Trade Covered Calls?
- The Downsides of Covered Calls
- Key Covered Call Metrics.
- Exmple Basis Calculations
- Covered Call Greeks
- The Major Tradeoffs
- A Secret Strategy
- What Plays to Avoid
- Designing Covered Call Screeners
  - A Baseline Screener
  - An Alternative List
- Some Trading Systems

A Covered Call Lifecycle Map

Delta Band Trading

TRADE EXAMPLES

WRAPPING IT UP

DISCLAIMER

WHERE THE CHARTS COME FROM

QUESTIONS OR COMMENTS?

Introduction

I first started in the stock market a decade ago using more traditional investing methods. The classic buy and hold and value approach appealed to me due to my belief that ownership in companies was a way to grow wealth.

My approach was a derivative of the Peter Lynch cliché *"invest in what you know."* I would carry around a Moleskine notebook in my back left pocket and would write down investment ideas as I walked through a mall or when I commuted to work. This was valuable education, but I know now that this approach is not suited for my personality and risk profile.

What I know now is that figuring out investment ideas will only take you so far. You can't just pick stocks without a good idea about position sizing, risk management, and yes-- a little technical analysis thrown in there as well.

I also know now that being **too smart** can actually hurt your returns. I am an engineer by trade and my entire life I was rewarded for being right. In the stock market you must figure out where you are wrong, because if you don't know that then you can't manage risk. Many trading accounts have been blown out by super-smart people who thought they could outsmart the market.

Luckily my math background did give me an edge in derivatives. I gravitated towards options because I understand how markets price risk and how volatility works when trading stocks. My ability to structure risk around a stock using option trades is where my edge lies.

I believe that consistent success in the market comes from the ability to systemize trade setups. It seems that much of the financial media is about trade idea generation-- what stock to buy, what to sell, what hot industry is around the corner and so on. But you rarely hear about **the framework** that leads investors and traders to make their decisions about entering and exiting these ideas.

My main trading strategies tend to be more complex and more short term, but retirement portfolios with a slightly larger timeframe are definitely suited towards covered call trading.

Financial Disclaimer

Here is my commonsense disclaimer. If you want the full legal rundown, it is available in Appendix A.

As with any financial speculation, you can lose a lot of money trading options. Because of the leverage available in the options markets, there are ways to lose your entire account very quickly. That's why you need to learn how to manage risk.

I'm not a broker, and nothing in this book is advice on how to buy or sell securities. You should not take this book as the gospel truth, and any investment decisions you make should go through a financial advisor.

This book is for educational purposes only, and that means you are personally responsible for your gains and losses.

What is a Covered Call?

A **covered call** is a very simple option position. This is one of the simplest trading strategies to master-- I believe that it is easier to learn than option buying!

A covered call is the combination of buying stock and then selling a call against the stock. The process of selling a call is also known as "writing," which is why a covered call is also known as a **"buy-write"** trade.

Let's talk about the mechanics of options so you can better get an understanding of what this trade accomplishes.

The options market is completely different than the stock market. When a company needs money to fund operations, they can raise capital through the sale of stock. The stock market is also known as a *capital market.*

The options market is not a capital market-- it is a *risk market.* Two parties come together to exchange risk. An option buyer is looking to remove risk, and the option seller is looking to take on risk. The main element in this exchange is the **premium** that risk is worth.

Figure 1: A Breakdown of the Risk Exchange in the Options Market

The options market is the kind of an insurance market. If you are trying to buy hurricane insurance in Florida in June, you will have to pay a high premium. If you try to buy hurricane insurance in Oklahoma in December, you will have to pay a low premium.

The **premium** is how much risk is currently being priced into the market.

Buy or Sell?

Now there are two kinds of options-- calls and puts. Because of this, we can add an extra dimension of risk as you can buy and sell either.

Calls give you the option to buy at a certain price. In exchange for this right, you pay a premium.

Puts give you the option to sell at a certain price. In exchange for this right, you pay a premium.

So far, so good, right?

There is also a difference between a call buyer and a call seller. The option buyer gets the legal right to transact stock, and the option seller gets the legal obligation to transact stock.

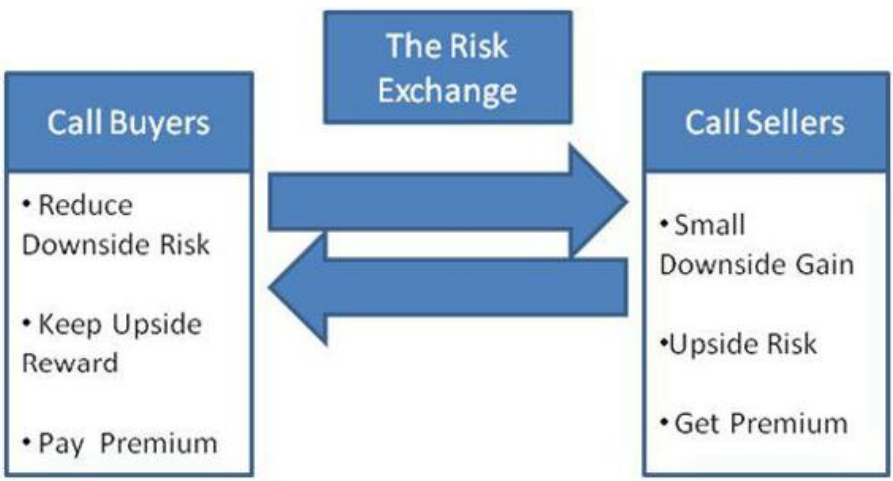


Figure 2: The Tradeoff Between Call Buyers and Call Sellers

Now remember, a covered call is a stock buy with a call sale, so let's consider what selling a call does.

If you sell a call that means you are assuming the legal obligation to sell stock at a certain price. This tends to trip up a lot of people because call = buy, right?

That's just for the option buyer. The call option buyer gets the right to buy, but as a call seller you have the obligation to sell.

If you just had the call sale on, this is known as a "*naked sale*" because you don't have stock to transact. If the call buyer wishes to transact stock, then you would end up being short stock, which is not always the best place to be. The naked sale is also a *net short position*,

meaning you lose money if the stock rises.

But the covered call has both a long stock position and a short call position. This means the covered call is a net long position -- you make money as the underlying stock rises.

Since we are option sellers, that means we are taking on a risk in exchange for some reward.

The risk in covered calls is both to the upside and downside. The downside risk is that the underlying stock tanks, which still leaves us at a loss.

But there is also upside risk-- because by selling the call we are in effect *limiting our upside*, which means if the stock rips higher, we make money but not as much as if we had just bought the stock straight up. This is a risk related to *opportunity cost.*

Well if we are taking on risk, we gotta get compensated for that, right?

Figure 3: Option Values Are Split into Two Components

There are two components to an option price: the intrinsic value and the extrinsic value. The **intrinsic value** is the relationship between the strike price of an option and the underlying stock. It shows us how advantageous the option would be to transact.

Anything left over is the **extrinsic value**. This is also known as the time premium, or the risk premium. This extrinsic value is the

premium paid for those who want to take on the risk, and it is the cost of insurance to those who want to reduce risk in a position.

Risks and Rewards

In order for me to properly explain how covered calls work, you will get a brief option greeks as it relates to this position. We will go into the option greeks more in detail later, but for a full, in-depth understanding of how option greeks work, check out my book "Option Greeks In Plain English: Mastery in Under 60 Minutes."

One cool thing about the option greeks is that complex positions aggregate the greeks-- that just means that they are added together.

Now while straight stock positions are not complex, they do have a single option greek: delta. This greek is the directional exposure in a position. This will also be the main greek to consider when entering and managing covered call positions.

Specifically, the **delta** is the sensitivity of the position value relative to the underlying stock price movement. Since a stock position's sensitivity is the same as the stock price movement, the delta will always be 1.

In a covered call setup, the position deals with 100 shares of stock for every short call. So for the stock position, we have a delta of 100.

We can represent this graphically with a payout diagram:

Figure 4: The Risk in a Long Stock Position

The delta of a short call is not constant so it gets a little more complex when analyzing this part of the position. In order to best understand it, we will look at the relationship of intrinsic, extrinsic, and expiration.

Imagine today is options expiration and you had purchase a call option with a strike price of $50, and the underlying stock is trading at $45. Would you exercise the call option? Of course not-- the call gives you the right to buy shares at $50 but you can just go purchase stock on the open market for $45 instead.

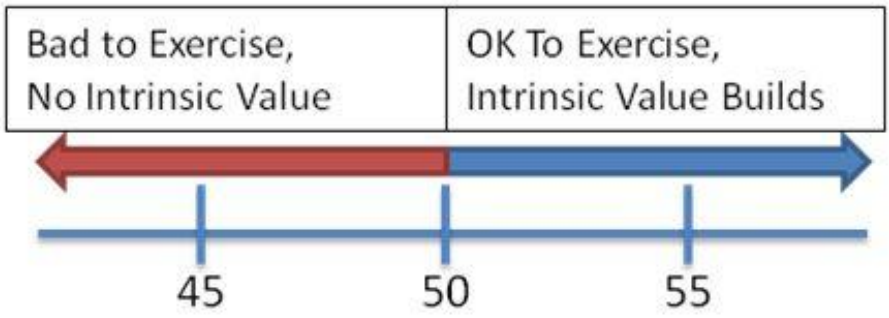


Figure 5: How Intrinsic Works on a Call Option

But if the stock were trading at $55, then it would be advantageous to use that call option. The intrinsic value is the relationship between the option strike price and the underlying stock price. It tells us exactly how advantageous it is to use that option.

Moneyness refers to how advantageous it is to use that option. An option that is "**in the money**" will have some intrinsic value.

Let's go back to the $50 call option. If the stock is trading at $55, what kind of value would you expect it to have? Keep in mind that options deal in 100-share increments.

At least $5.00, because that's the difference between the stock price and the strike price. If it were any less, the market makers would arbitrage the play by selling stock and buying the call.

What would happen to the value of the call if the stock went from $55 to $56? The option value would rise by $1.

In fact, at expiration the intrinsic value follows a 1:1 tracking, just like long stock!

Now what about options that are "**out of the money**"? These are options that have no advantage to exercise at expiration. If the stock is trading at $45, then our $50 strike call option doesn't do us any good.

And what happens to the intrinsic value if the stock rises from $45 to $46? Nothing, because it's still not advantageous to use the option to buy stock.

So at expiration, the intrinsic value follows a 0:1 tracking, as if there were no exposure at all!

Notice how we are only talking about intrinsic value. There is another component called extrinsic value, which is related to the risk premium in the option. But since we are at options expiration, there is no time value in the option, and therefore no risk premium.

So here's what we know

- 100 shares of stock will always have 100 deltas

-"in the money" calls at expiration will have 100 deltas

- "out of the money" calls at expiration will have 0 deltas.

Figure 6: Opex Payout of a Short Call

And since the directional exposure is *in aggregate,* we can simply add up the two positions together to get the payout for a covered call:

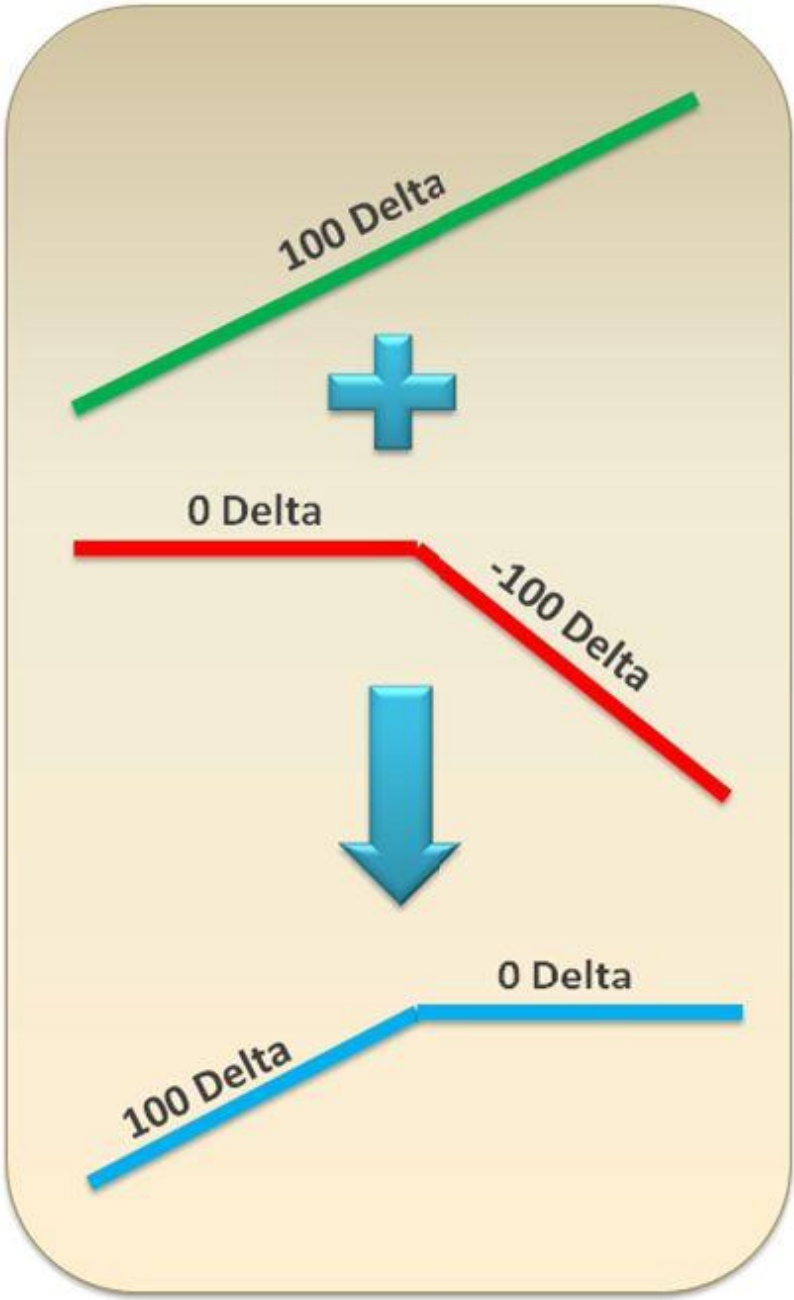


Figure 7: Constructing a Covered Call Payout

But what if we want to model a position payout before options expiration? What do we need to consider?

Remember that long stock doesn't change. 100 shares are 100 shares. So all we need to do is focus on the short call option.

Up until now, we've been discussing how a call acts around options expiration. This is so we can isolate the intrinsic value. But now we need to look at the extrinsic value, also known as the risk premium.

The **extrinsic value** is whatever is left over in the option price after intrinsic value is looked it. This is the premium you pay to buy the option, or the premium you receive to sell the option.

The option market is a risk market, and the **extrinsic value is the risk pricing.**

I don't want to step you through big ugly equations that show how risk is priced in the market-- we just need to know it is there and it adds to the value of the option.

Here is what a covered call payout looks like at t-0 -- this means "right now" instead of at options expiration.

Figure 8: Covered Call At Opex vs. Right Now

If you notice the difference between the two, you will see that you make money if the stock moves higher but doesn't move at all. You also can lose money if the stock sells off, and you can lose money faster if the stock sells off very quickly.

With that description we know that this position greeks are:

- long deltas (you make money if the stock goes higher)

- long theta (you make money if the stock doesn't move)

- short gamma (you lose money if the stock moves fast)

We will discuss the greeks in detail later.

Risk And Reward

When you trade options, it's not just about knowing whether the stock will go up or down. It's about how fast the stock will move, and how long it will take to hit certain price targets.

So we can consider two additional factors - price, and volatility.

A covered call is bullish on price, it means that your risk/reward is tied to the stock going higher.

Also, a covered call is **bearish on volatility.** This means your risk/

reward is tied to how fast the stock will move.

Why Trade Covered Calls?

From looking at the payout diagram above, you should have a pretty good idea how a covered call will operate. With that in mind, you can learn about the main reasons why covered calls are an attractive trade.

1. You don't have to be a perfect market timer.

Because you are selling a call against your long stock, this gives you a lower directional exposure, which reduces the volatility in a position. On top of that, the position makes money over time, even if the stock doesn't really move. The covered call gives you a way to reduce your basis in a position, so trying to "nail a trade" doesn't matter as much. This has a profound impact on your trader psychology as you no longer feel forced into a trade or worry that you are chasing.

2. Better risk adjusted returns.

By reducing your risk and increasing your potential reward, you have the ability to gain a further edge in the market. If you combine covered call tactics with sound asset selection then you have the formula for a great investment strategy.

3. Reduce your basis over time.

There are times in a covered call where you can close out the short call for a profit and open up a new short call further out in time. This gives you the ability to reduce the cost basis in your position even further, thereby decreasing your risk and increasing your reward.

4. Does great in choppy markets.

Stock markets tend to have two or three really good trends in the year, and then are directionless as market distribution comes into play as well as sector rotation. Covered calls do really well in this environment as you can make money even if the market goes nowhere.

Essentially, if you can get a good feel for when a stock will rise, you don't have to have a perfect entry and can still make money. Couple that with a solid risk management system and you're set for a stronger portfolio.

But, there is a problem....

The Downsides of Covered Calls

Just like any other investment or trade out there, covered calls are not a perfect strategy. In fact, it's a good idea to have some discretion about the trade, and use market context to dictate whether covered calls are the best idea. Here are some downsides of covered calls-- learning to avoid these downsides will make sure you only select the best trades available.

1. You get limited upside.

A covered call position is a net option selling position. You are a receiving a premium in exchange for reducing the upside risk in your position. Most traders don't even consider upside risk, but it can have a significant impact in your trading.

Let's say you are long stock at $50 and you short the $55 call. If the stock farts around (technical term) or moves up $5 then this was a good trade. But if the stock gets acquired and jumps $70, then you have a problem. Sure, you made money, but you also missed out on further upside gains. *There is an opportunity cost to consider when trading covered calls*. If you think there is much more upside in a stock, then you need to take the other side of the trade and go long calls.

2. Covered calls underperform in big bull markets.

This is an extension of the previous point. If the stock market enters some brave new world where stocks are moving up 3-5% daily, then your covered call strategy will have you missing out on a lot of gains. There is a time to be aggressive with risk, and times to be conservative-- there is no easy way to distinguish between the two, and I believe that the understanding of market context comes through experience.

3. New psychological issues.

Because you are now short volatility and short gamma, you will run into what's known as "mean-reversion bias." This often happens with option traders who always think the market has gone up too far or down too far, and are often late to the trend. I know this, because I am one of them.

There is also something called "anchoring bias" with your short call. If you sell a 65 call against stock, your mind will now be imprinted with that 65 level, even if there is no clear market structure around it. Time

spent too far away from that number will be met with mental anguish as you want a “perfect pin” at that level.

4. Falling into a value trap.

Just because a stock is oversold doesn’t make it a buy. And just because you can use covered calls to reduce your basis doesn’t mean you should. Be wary of “value traps” -- stocks that start to look appealing because they’ve been hit aggressively by sellers. Sometimes the sellers are justified and the stock continues with its downward momentum.

Using covered calls as an investment or trading strategy is a great idea, but not always the best idea. Learning to identify riskier market environments-- both upside risk and downside risk-- will help you decide whether being an option seller is the best choice at that time.

Let's now talk about important numbers to consider when looking for potential trade candidates with covered calls. We will first cover the definitions, and then go directly into some examples.

If you don't want to calculate these by hand, don't worry-- your options brokerage can calculate these for you, or you can use the Covered Call spreadsheet provided to you in the bonus section.

The Basis

In normal stock trading, the basis is short for "cost-basis." It is the value of the position. If you buy 100 shares at $50, your basis is $50.

If you buy 100 shares at $50 then buy another 100 shares at $45, your basis will be $47.50.

With covered calls, your basis is calculated as the initial cost of the stock minus the premium that you receive. Do note that the calculation doesn't include the overall value of the option, because the intrinsic value is related to the stock price.

The basis calculation is calculated conditionally:

If the option is OTM, the basis is the value of the stock minus the value of the option. We can do this because the entire option value is extrinsic value.

If the option is ITM, the basis is the strike price of the option minus the extrinsic value of the option.

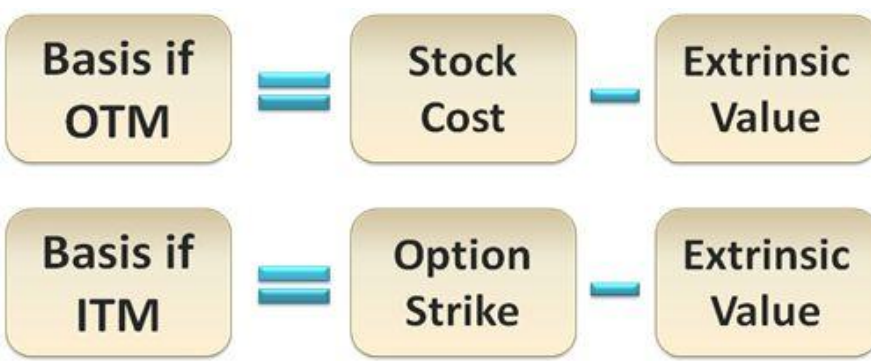


Figure 9: Finding the Basis for a Covered Call

There are other methods to calculate the basis, but I choose this way because you will understand covered calls better if you focus on the extrinsic value in the option and how extrinsic changes over time and over price.

The Return on Basis

The **RoB** is critical to understanding risk, reward, and odds. If you are putting on a ton of risk for not enough justifiable reward, then the trade may not be worth it. But if the extrinsic value is high enough to make the call sale worth it, then you want to take the trade.

To calculate the return on basis, we must figure out the **max return** the covered call can receive. Because the reward in a covered call is limited, this is fairly straightforward.

Maximum return is the difference between the option strike and the basis. This is effectively the highest transactional value that you can receive.

Now if your call is "in the money" (ITM), it means that the value of the stock is higher than the value of the option strike. It may seem as though the transactional value would be lower. But because we calculate the basis for ITM options a little differently, then this issue is worked out fairly simply.

Figure 10: Calculating the Max Return

A quick note: if you own the stock during a dividend, then you will need to include the dividend in either the basis or the max return.

Now to calculate the return on basis, you simply divide the Max Return by the Basis. This will give you a percentage.

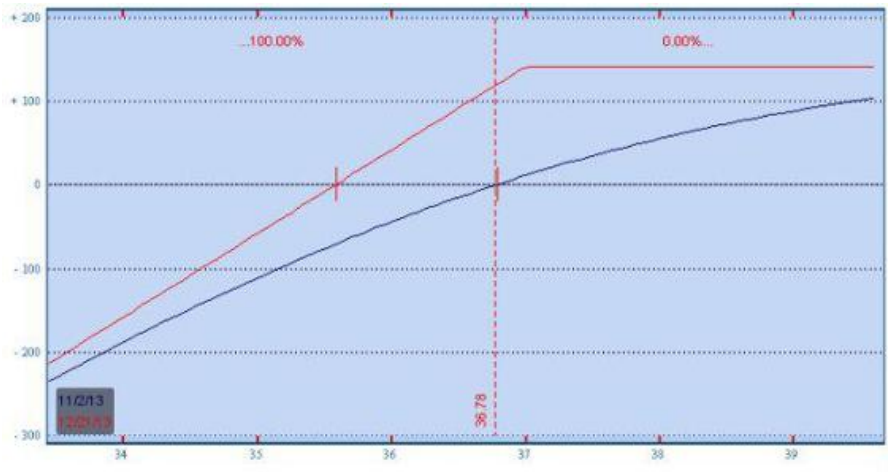
Figure 11: Calculating the Return on Basis

This value will tell you the max net return that you will receive, and it can also be a good guide as to whether you want to enter the trade or not. If a covered call gives you a return of 3% but you think the stock will move higher by 6%, then you want to just buy the stock and maybe roll it into a covered call later.

Calculating the return on basis gives you a more practical approach when valuing options, especially if you haven't fully grasped exactly how options are priced.

Example Basis Calculations

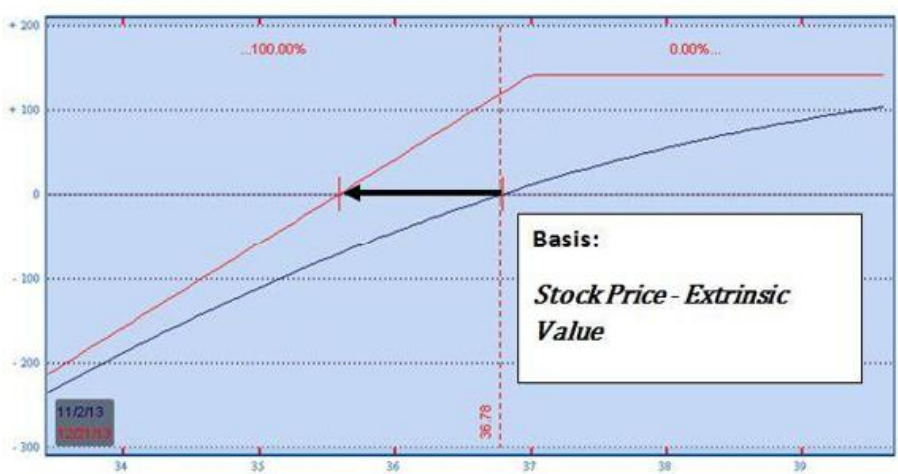
Let's take a look at a potential trade in Freeport McMoran & Gold (FCX)



This covered call is where we buy 100 shares of FCX at a price of 36.78 and then sell 1 Dec 37 Call against it for 1.20.

This trade makes money as long as we stay above our basis before December expiration.

To figure out our basis, all we have to do is subtract the value of the option from the buy point of the stock.



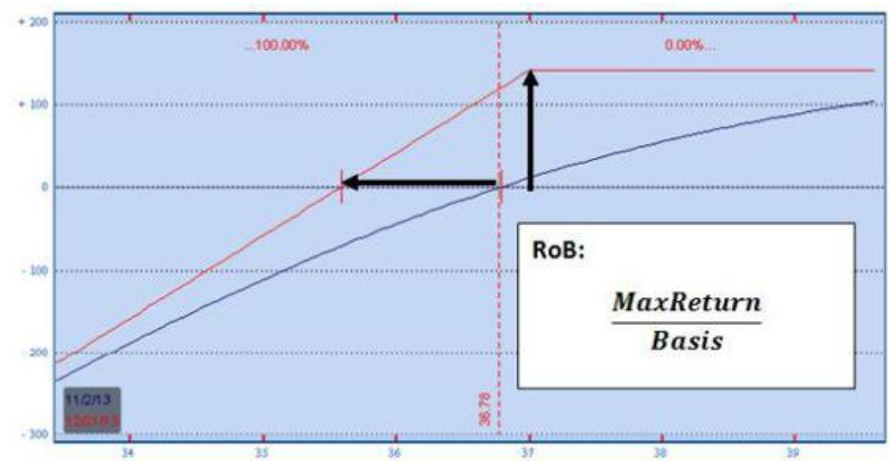
36.78 - 1.20 = 35.58

To calculate the max return, simply take the strike price of the call and subtract it from the basis:

$$37 - 35.58 = 1.42$$

So that means you can make $142 at most on this play.

Placing the max return in percentage terms is important so you can analyze different stocks with different prices and volatilities. Let's calculate the return on basis (RoB):



$$1.42 \div 35.58 = 0.039 \rightarrow 3.9\%$$

This means that if this trade is successful you can make about 4% return on your capital.

These are the main metrics you will be dealing with when using covered calls. Let's take a look at some other calculations:

Annualized Return on Basis

This value is what you would expect to make if you were able to take a single covered call trade over and over for a year. If you had a covered call that gave you an RoB of 3% in 30 days, then the annualized return on basis is 36%.

These calculations are done automatically with most option software. Here is an example from TD Ameritrade (thinkorswim):

CALLS					
Cov Ret...	Max Co...	Bid X		Ask X	
5.47%	5.47%	4.00	X	4.10	X
8.51%	8.51%	3.15	X	3.25	X
13.17%	13.17%	2.41	Z	2.45	X
19.66%	19.66%	1.74	I	1.76	A
24.22%	28.68%	1.18	H	1.21	A
15.61%	40.33%	.76	Z	.78	A
9.53%	54.52%	.46	H	.48	I
5.47%	70.73%	.26	H	.28	Z

The left hand column shows us the "Covered Return," which annualizes out potential returns from the call sale alone. It is a function of strictly the extrinsic value.

The "Max Covered Return" shows you the annualized gains of both stock price movement as well as any gains from upside movement in the stock. This is a more "idealized" scenario.

Notice that while the Max Covered Return value continues to increase, the Covered Return will decrease. This shows us that if we choose higher strikes for our covered calls, more and more gains will be a result of the stock price movement instead of gains from the call sale. This will be important when we discuss tradeoffs.

If you're impressed by these "annualized" numbers, be wary. Advertisers will sneak in the annualized RoB to show you the potential of covered calls, but this assumes optimum conditions--meaning that the stock goes higher every single month. When we include volatility and drawdowns, the actual returns will be lower

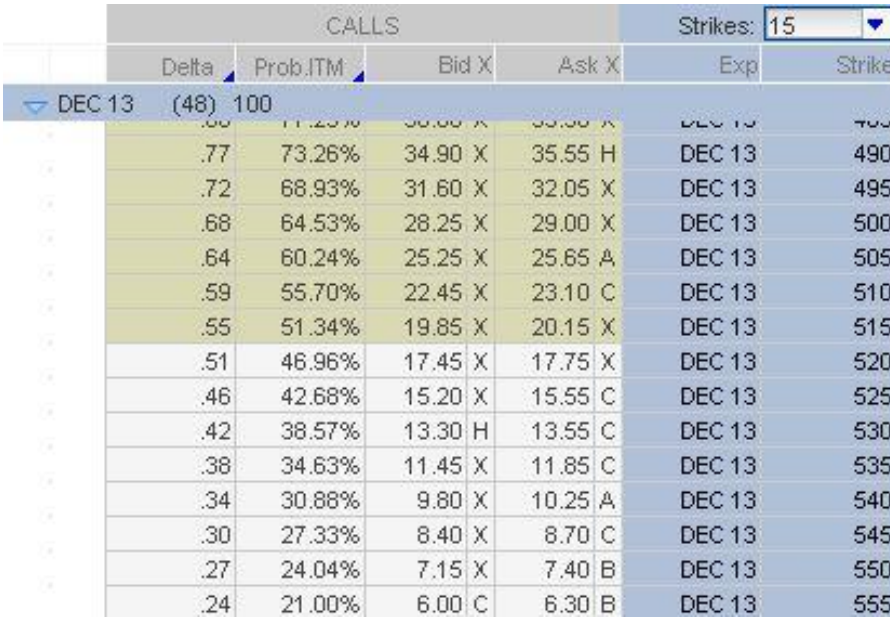
than that-- but still very impressive.

Calculating the Odds of Max Return

Because of market volatility, you won't know if you will get max return-- but with option pricing we can figure out the odds that you will get that max return.

An option delta is the directional exposure the option has relative to the stock price movement. If an option has a delta of 40, that means for every $1 the stock moves, the option will move by $40

By some mathematical trickeration, the option delta is also related to the odds that the option will expire in the money.



CALLS				Strikes: 15	
Delta	Prob.ITM	Bid X	Ask X	Exp	Strike
DEC 13 (48) 100					
.77	73.26%	34.90 X	35.55 H	DEC 13	490
.72	68.93%	31.60 X	32.05 X	DEC 13	495
.68	64.53%	28.25 X	29.00 X	DEC 13	500
.64	60.24%	25.25 X	25.65 A	DEC 13	505
.59	55.70%	22.45 X	23.10 C	DEC 13	510
.55	51.34%	19.85 X	20.15 X	DEC 13	515
.51	46.96%	17.45 X	17.75 X	DEC 13	520
.46	42.68%	15.20 X	15.55 C	DEC 13	525
.42	38.57%	13.30 H	13.55 C	DEC 13	530
.38	34.63%	11.45 X	11.85 C	DEC 13	535
.34	30.88%	9.80 X	10.25 A	DEC 13	540
.30	27.33%	8.40 X	8.70 C	DEC 13	545
.27	24.04%	7.15 X	7.40 B	DEC 13	550
.24	21.00%	6.00 C	6.30 B	DEC 13	555

Figure 12: You can see how delta values are directly related to the odds of expiring in the money

Through a little common sense we can see how this works. An at-the-money option will have a delta of around 50. We also know that at any point in time, a stock has about a 50% chance of going higher or lower-- at least that's what the option pricing models tell us.

The more out of the money we go, the lower the delta and lower the odds. The more in the money we go, the higher the delta and higher the odds.

So when will a covered call get max return? When the option goes in

the money. What are the odds we go in the money? It's about the delta of an option.

If you buy stock and sell a 30 delta call, the statistical odds that the option will expire ITM is 30%, which means your odds are around 30% of max return.

Keep in mind that these odds are based off mathematical models. It assumes price movement is pretty random--if you can time stocks or use technical analysis, you can get an edge.

Why is this important?

Because there is a tradeoff between risk, reward, and odds. If you sell a higher delta call, you will have lower directional risk, higher odds, and lower rewards. If you sell a lower delta call, you will have higher directional risk, lower odds, and higher rewards. This fact is inescapable, and it is the main issue we address when choosing the best options to sell in a covered call.

Before we can address the tradeoffs, we need a look at the true risks of an option, also known as the Greeks.

Covered Call Greeks

What do you care about when you trade stocks, futures, commodities, forex, and bonds? You care whether or not the asset goes up or down. That's where the risk is-- higher or lower.

With options there are other things to worry about. Because an option eventually expires, the market tries to price the option as a function of risk. But the risk isn't just about higher or lower, it's how fast and how long it takes to get to certain prices.

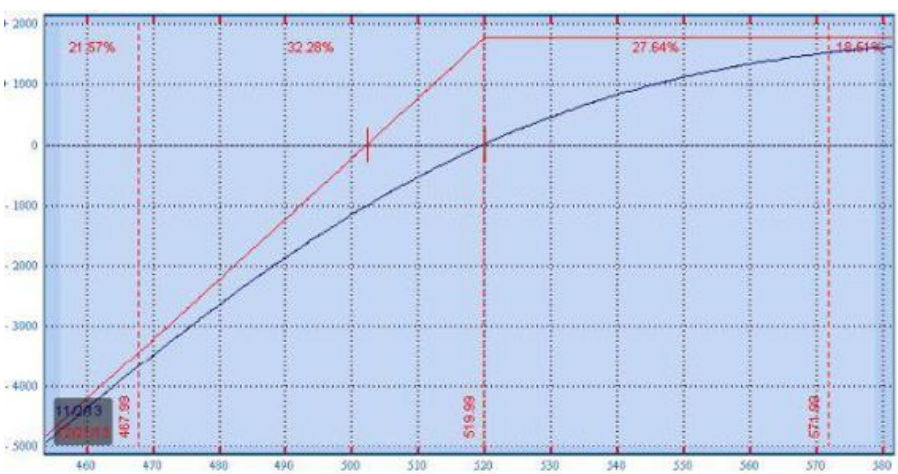
These risks are known as the **greeks**. It's about how an option position changes over price, time, and volatility.

This is going to be a cursory overview of the greeks as they relate to covered calls. For a more in-depth explanation about how the greeks work, check out my book "Option Greeks in Plain English: Mastery in Under 60 Minutes."

Delta

We've already discussed delta in detail when it comes to how to construct an option. But now we will see how delta acts in a covered call.

Let's start with an example of an AAPL covered call:



For quick reference-- the top line is what the position looks like at expiration, and the bottom line is what our position looks like right now.

Again, the delta of an option is simply how much money you make or lose when the stock moves. Since covered calls are bullish positions, it means this is a long delta position.

But delta is not constant. It can change. And that leads us to...

Gamma

This is where things get a little tricky.

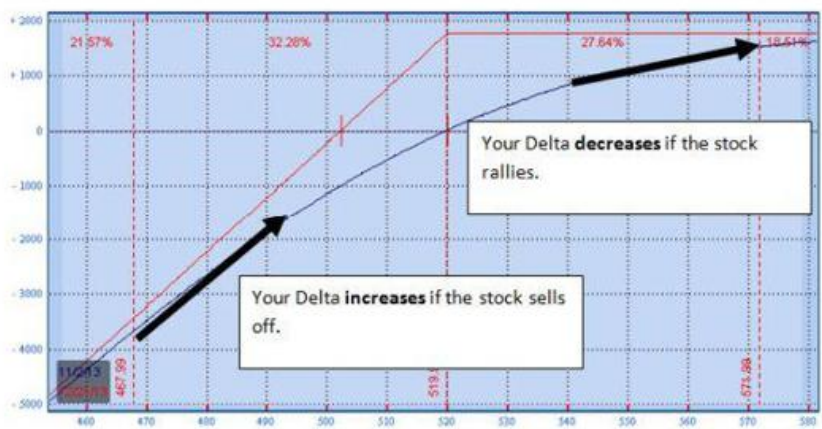
This greek is the change in delta relative to the change in the stock.

Instead of getting into heavy math, think about this intuitively.

If the stock sells off, the sold option becomes worthless, and all your exposure is related to the stock position along.

And if the stock rallies, the sold option will start to negate the exposure, meaning your directional exposure (delta) comes close to 0.

Taking a look at the graph, we can look at the delta-- it is simply the **slope** of the p/l line.



By this reasoning, it proves that your position risk is not constant. In fact, it increases if the trade goes against you. That's the main tradeoff when you are a net seller of options-- you feel that the risk isn't that great relative to the premiums (rewards) the options market is giving you.

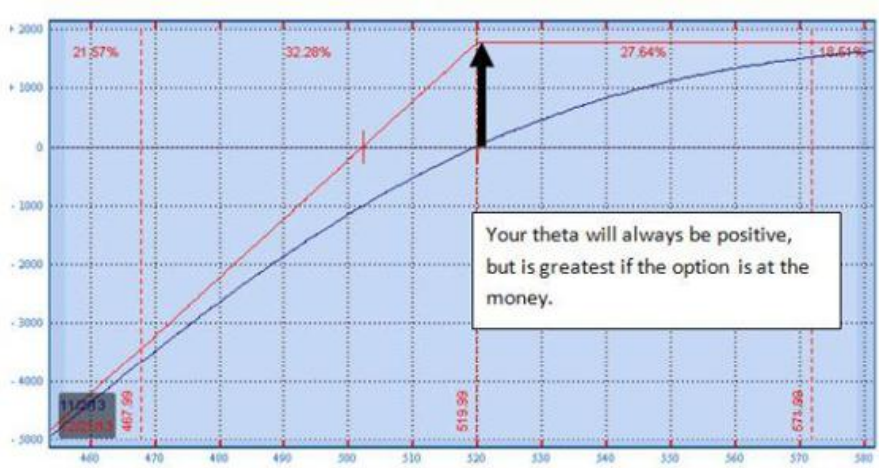
So why would you have such an adverse risk profile?

That leads us to...

Theta

This is a greek that tells you how much money you make or lose as time goes on.

Remember, options are decaying assets-- and since you are short calls, the premium decay works in your favor.



The theta rewards are what make the gamma risks worth it.

Finally there's one more greek to discuss...

Vega

Let's start back with a foundation that we can construct the concept of vega. An option value is composed of intrinsic value and extrinsic value.

The extrinsic value is also known as the risk premium. We can measure the risk premium across assets by doing some fancy math and we come up with a number called the **implied volatility**, which tells us how much volatility the options are implying-- simple, right?

If the perception of risk rises, then what do you think happens to the risk premium? It goes up, which means that the extrinsic value goes up and the option value goes up.

Since covered calls are an option selling strategy, you will be **net short vega.** This means you make money if the implied volatility goes lower, and you lose money if the implied volatility goes higher.

When you pick covered call candidates, you want to get into names that you expect volatility, both implied and actual, to decline.

There are many instances in which implied volatility is too low. This means that the premiums available are not worth the risks you take.

If you think that the volatility in a name will be much higher, then you want to use a different strategy that is net long vega.

With a clear understanding of the risks (Greeks) involved, you should have a good picture as to that the tradeoffs are in covered calls. Let's take a look at some of the main considerations.

Premium vs. Risk

If a stock option has a higher amount of premium, then you can get larger returns from selling that option.

The problem is... option premium is "rich" for a reason. It may have earnings coming up or may be a takeover target.

Conversely, the boring, low-risk stocks will have option boards that are low-priced. These will be more "certain" plays, but the market often prices that risk (or lack thereof) accordingly.

In other words, you get what you pay for.

There will, of course, be times in which an options market will over or underprice the stock's volatility. As you develop volatility analysis techniques, you can use those to help get an edge in your covered call trading.

Theta vs. Gamma

If there is one tradeoff you will never get away from, it's the tradeoff between theta and gamma. If a call sale offers you a massive amount of theta (time premium gains), it will always be tied with massive gamma risk.

This is especially true when dealing with weekly options. Due to the exponential decay function related to theta, the bulk of your theta gains will come through in the last few weeks of an options lifecycle.

But that also means you are exposed to a higher position variance. This is a function of how your delta changes over time (also known as charm). At expiration, the delta of a covered call is either 0 or 100. That means if a trade starts going against you right at expiration, it will go against you really hard.

It's what I call the gamma knife edge. And I've been cut on it plenty of times.

The tradeoff is-- if you select a call option that is too far out in time, it

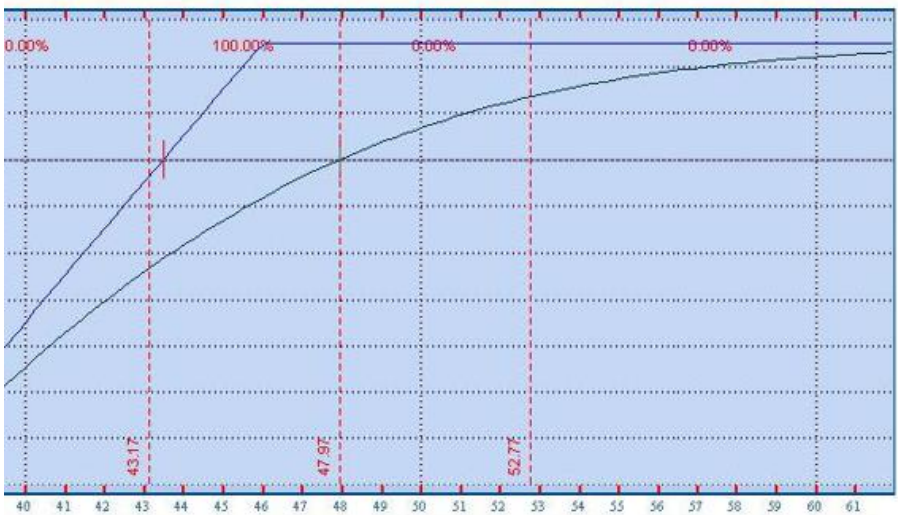
will take forever to realize any sort of theta gains. The benefit would be that you aren't stuck on the gamma knife edge

A Secret Strategy

There's an alternative to a covered call strategy that offers you the same risks and rewards, but with a reduced cash outlay.

A **put sale** gives you the legal obligation to sell stock at a certain price by a certain time. This is a long delta trade, with a limited risk payout for theoretically unlimited reward.

Let's take a look at the payout diagram for a put sale:



Looks awfully familiar, doesn't it? That's because covered **calls and put sales are equivalent** with respect to the risks.

There are a few advantages for using put sales over covered calls:

Reduced capital requirements. If you are using a margined account, selling puts will require a fraction of the capital compared to buying stock in a covered call position. The risk here is that you can get overleveraged, but if you use that extra capital wisely (like for hedging positions) then it can actually help you manage your risk.

Reduced Commissions. Instead of having to pay to trade stock and options, you can just trade the option. That "discount" can add up over time.

Simpler Exit Execution. If you are right on a short put, then all you have to do is let it expire worthless or buy it back at a very low price. Many option brokerages will not charge commission if you buy an

option back at very low prices.

Compare that to a covered call. If you are right, then the stock will rally and your call will go in the money. This also means that the bid/ask spread will widen out (it's what happens to ITM options) which makes it difficult to exit if you want to.

When we get into the trade lifecycle, I will show you how it's a great idea to first start with put sales with the potential to evolve into a covered call.

Here is the main tradeoff when it comes to covered calls: if the risk premium available in the calls is higher than the risk we take, then we should get into the trade. Let me explain a little further.

The option market is all about probabilities. We don't know if a stock will go up or down $5, but we can assign odds. Those odds are how the market determines the risk premiums (extrinsic) available in the options.

If the market is pricing in a $7 move to the upside, but we think that the stock will move up only $5, then we should pick up covered calls. However if we think the stock will move up $15, then we should use a different strategy like call buys.

A covered call position is great when you are bullish on a stock, but don't think there will be an explosive move higher. In more advanced terms, you think that the probabilities of asymmetric rewards are lower, but you can still think that stock ownership is a wise choice.

What does this mean practically?

Let's take a few examples to show you when covered calls are a terrible idea.

Keep in mind that there will always be exceptions, but these rules hold up fairly well.

FDA Events

There are a select group of stocks called "biotechs." These companies often have binary risk around an event-- generally an FDA event. These companies have been working hard on drugs to help people, but they don't know how well those drugs work and whether they will be approved in the U.S.

Often the company will have a date in which they release a clinical trial that shows the result of those drugs. If the drug works, it will give the stock a massive boost as a new revenue stream is opened up. However, if a trial fails or the FDA rejects it, then the stock collapses as it has no potential for future cash flows.

Because of this binary risk, the options market will see a massive rise in the premiums. This is like how home insurance premiums rise if a hurricane is about to hit.

Figure 13: Dendreon is a great example of biotech risk

Many investors will think that the "fat premiums" that are available make covered calls an attractive choice-- but too many times the asymmetric risk takes hold and wipes out a position. And even if the trade works, the covered call limits the upside which means you aren't paid enough to justify the risk that you take.

Momentum Stocks

Companies that have an opportunity for massive growth will not be the best candidates for covered call trading. It comes back around again to the idea of risk and reward. With covered calls you are limiting your upside reward.

This means that if you are investing in a company with asymmetric rewards then it's not the best idea to limit your upside. Sure, you may now have better odds on the trade but over time it will not be a profitable system.

Figure 14: Covered Calls Will Lock You Out of Potential Upside

One of the main components of a momentum based trading strategy is to have that 10% of your investments make 80% of your profits. You can't accomplish this using covered calls.

Low Volume Stocks

A major risk in options trading is liquidity risk. If a stock doesn't trade much volume, it stands to follow that there won't be many options traded as you need a lot of market participants that need ways to reduce risk.

The problem with low volume stocks ends up being that if you enter an option position and want to exit, you won't be able to exit with good fills. This slippage is part of that liquidity risk, and it can add up over time.

Low Price Stocks

All other things being equal, a $20 call option will be more valuable than a $2 call option. This means on an absolute basis you will receive more premium on higher priced strikes.

Why does this matter? It comes down to commissions.

Let's say you pay $1.50 per option contract and $5 for stocks. That

means to enter into a covered call, it will cost you $6.50. And if you need to exit, then that's another $6.50 for a $13 roundtrip.

If you are putting on a covered call on a low-priced stock, the trading commissions will eat up a significant amount of your trading profits.

0	278	1.58 T	1.62 X	DEC 13	1.5	0 Z	.02 N	40	930
140	3,326	1.11 N	1.14 A	DEC 13	2	.03 C	.05 X	40	2,559
214	4,962	.68 X	.71 N	DEC 13	2.5	.11 I	.12 Z	7	4,664
1,424	7,681	.38 N	.40 C	DEC 13	3	.29 X	.31 N	621	2,504
1,831	13,791	.20 Z	.21 N	DEC 13	3.5	.61 I	.64 I	71	2,902
595	11,602	.10 X	.11 Z	DEC 13	4	1.02 N	1.04 I	0	347
33	6,032	.05 X	.06 N	DEC 13	4.5	1.45 C	1.53 X	0	100
0	3,206	.03 X	.05 I	DEC 13	5	1.93 C	2.00 X	0	57

Figure 15: Even though this option board is liquid, it's not worth trading

The Problem With Most Screeners

There are plenty of solutions out there for you if you want to find the "best covered call" to trade.

But many of these solutions are lacking.

It comes back to the "fat premium" trap. Just because a stock option has a very high amount of premium, that doesn't make it a sale.

But that's the starting point for many of these screeners. They look to maximize the reward in the covered call without taking into account any sort of risk. This means that any list you pick up will be full of companies that report earnings in the near term or are biotech hand grenades.

A Baseline Screener

To fix this problem, you need to first find the best stocks from a risk management perspective. These are going to be larger cap companies with plenty of liquidity and are in uptrends.

6 Simple Steps to a Good Stock Watchlist

Key Resource: Finviz.com -- I love this site. There's a ton of data visualizations that can give you a better feel for how the market is trading, as well as screeners and tools to make you a better trader. We will be using their free screener in this section. You can find it here.

When you first open up the finviz screener, you will see a list of over 6,000 stocks and etfs.

Overview | Valuation | Financial | Ownership | Performance | Tec

Total: 6447 #1

No.	▲ Ticker	Company	Se
1	A	Agilent Technologies Inc.	Healthcare
2	AA	Alcoa, Inc.	Basic Mater
3	AACC	Asset Acceptance Capital Corp.	Financial
4	AAIT	iShares MSCI AC Asia Information Tech	Financial
5	AAME	Atlantic American Corp.	Financial
6	AAN	Aaron's, Inc.	Services
7	AAON	AAON Inc.	Industrial G
8	AAP	Advance Auto Parts Inc	Services

Figure 16: The Starting Blocks for Our Screener

It would be foolish to think that we can step through every single stock to find the best trading instrument, so we will first apply some common sense filters to give us a baseline stock list.

Step 1: Remove ETFs

The first one is to select "Industry -> Stocks Only." This will remove all ETPs out of the picture-- there is a time and place for market and sector bets but we are looking at companies for now.

This takes us down to around 4,750 stocks.

Step 2: Make Sure they Have Options

The next filter to apply is "Optionable and Shortable." If the stock has no options then we can't do covered calls, and having the ability to short makes sure that the market can be a little more 2-sided.

This takes us down to 3,350 stocks.

Step 3: Remove Liquidity Risk

With the introduction of weekly options and the maturation of the algorithmic industry, the options market has become a little bit more "inbred." This means that the majority of the trading volume tends towards the same stocks.

0	1,282	10.90 Q	11.90 Q	JUN 13	39	0 Z	.30 C	0	1,138
0	1,104	10.10 Q	11.30 Q	JUN 13	40	0 Z	.35 C	0	550
0	446	9.10 N	10.00 C	JUN 13	41	.05 C	.40 C	0	371
0	342	8.10 C	9.00 C	JUN 13	42	.05 A	.45 C	0	2,297
0	317	7.60 C	8.10 C	JUN 13	43	.15 X	.45 C	0	12,793
0	386	6.60 C	7.10 C	JUN 13	44	.15 Q	.45 T	0	1,233
1	535	5.60 C	6.10 C	JUN 13	45	.20 C	.45 C	0	435
0	2,186	4.70 C	5.10 A	JUN 13	46	.20 C	.45 N	0	22
0	1,004	3.70 C	4.20 C	JUN 13	47	.30 C	.50 B	8	41
0	457	2.85 C	3.30 C	JUN 13	48	.40 C	.65 C	0	23
10	1,520	2.10 T	2.40 N	JUN 13	49	.60 C	.85 C	0	24
0	382	1.45 I	1.70 A	JUN 13	50	.90 A	1.15 C	0	10
0	0	0 Z	.20 C	JUN 13	55	4.30 A	4.70 C	0	0
0	0	0 Z	.15 C	JUN 13	60	9.20 C	9.60 Q	0	0
0	0	0 Z	.15 N	JUN 13	65	14.20 C	15.10 N	0	0

Figure 17: An Example of a Non-Liquid Options Board

This means that even though a stock is optionable, it doesn't make it a good trade. Many times a stock's options will have very little trading volume as well as a wide bid/ask spread. You can end up with

liquidity risk, meaning that exiting the trade will be very difficult and you will incur further slippage.

To reduce this risk, we will apply a volume filter: "Average Volume -> Over 1M"

If the stock has a demand for liquidity, it often means that the options have a demand for liquidity.

This takes the list down to 1,000 total stocks, but we can go further.

Step 4: Higher Share Price

Due to the cost of commissions, trading covered calls on low priced stocks is not always the best trade. Instead, focus on higher priced names by applying the filter: "Price -> Over $10"

We are now down to around 800 stocks to look at. It's getting a lot more manageable.

Step 5: Bigger Companies

Smaller capitalization companies are stocks that can generate higher rewards but with higher risk.

When you invest in smaller cap companies, the bulk of your gains will come from price appreciation. When you put on covered calls, you limit the price appreciation, so it can actually reduce your risk-adjusted returns.

Covered calls are best suited to larger companies, not high growth firms. We can filter this out by selecting "Market Cap -> +Mid (over $2bln)."

We are now down to around 700 companies.

Step 6: Stick With The Trend

A major issue with covered calls is the "value trap," where you think the stock is low enough to justify a wise investment.

I don't have deep pockets, which means I don't have the patience or the need to stay in losing stocks forever until their value is realized. Instead, I can wait for the bigger participants do the heavy lifting for me to turn a stock around.

A simple technical filter can be applied here: "200-Day Simple

Moving Average -> Price above SMA200"

This takes the list down to around 600, and will depend on how mature the market trend is. This is the baseline screener.

Link to Your Finviz Baseline Screener

Quick note: Some of these filters may need to be adapted depending on market conditions. For example, the 2008 market crash led to share price, trends, and market cap shrinking across many stocks, so reducing those to find candidates was a good idea back then.

An Alternative List

If all you want is a list of stocks with liquid options, the simplest thing to use is the Penny Pilot Program List.

The Penny Pilot Program is an initiative by the CBOE to tighten up the bid/ask spread on option markets. This allows traders to achieve better fills on their positions, which in turn (should) increase liquidity. These stocks are chosen by investor interest and pre-existing liquidity. So if you want to focus on liquid options, this is a great place to start.

You can learn more about the PPP here.

Some Trading Systems

Understanding the mechanics of covered calls is simple compared to developing profitable trading systems. In this section we will discuss some of my favorite setups that use this strategy.

Pullbacks or Breakouts?

Because covered calls are a short gamma, long theta kind of strategy, I tend to focus on contrarian plays. There's a very specific reason for this.

When a stock sells off, investors get scared. They either start to dump the stock (which leads to more selling) or they will buy protection. If they buy protection, it means that the demand for options rises, which means the premium rises.

By selling covered calls in this environment, it allows you to sell higher premium. This means you can get a better risk-adjusted return compared to a market that is more complacent.

Keep in mind, by going long when a stock is selling off aggressively, it often means that you won't see "instant" profits.

The timeframe on these kinds of trades are months, not weeks. The goal is to enter into a position with the intent of selling options against it to work down the stock basis to very low risk levels.

Setup 1: Bollinger Band Buy

On a daily chart, overlay a Bollinger Band with a sampling period of 50 days and bands of 2 standard deviations.

If a stock sells off into the lower Bollinger Band, start looking for signs of support on a 30 minute timeframe. From there you can enter a position.

Setup 2: Failed Breakdowns

When it comes to basic technical analysis, sometimes the best bet is not to play the chart, but to understand what everyone is thinking about the chart.

There are times where a "captain obvious" support level exists on a chart, and a ton of discretionary traders are anchored onto that level.

Then the level breaks, and it looks like all hope is lost, right? Not so fast. What happens here is that all those traders will stop out of their trades, but an institution is willing to buy at those prices. Then we see a sharp reversal back above that level, leaving the new stock holders in a position of power.

This "failed breakdown" strategy is a great opportunity to put on a covered call strategy.

Setup 3: Buy the Blood

The final setup to observe is more of a market based setup. This is a good timing mechanism if you are waiting for a general oversold indicator to occur in equities.

In this setup we look at the VIX, which is the supply and demand for S&P options. When the VIX spikes higher, it often indicates fear in the markets-- but we don't stop there.

Like the failed breakdown strategy, we are looking for smart money and dumb money.

The first thing to look for is a statistically significant move above the upper Bollinger band - 20 day sampling period this time. The first spike in the VIX is often smart money getting ready for a downside move. We use that candle's high as a reference level.

The next thing we look for is a pullback, then a spike above that reference level. This is the equivalent of a jab, right hook-- the first hit isn't that bad, but the followup can be downright nasty.

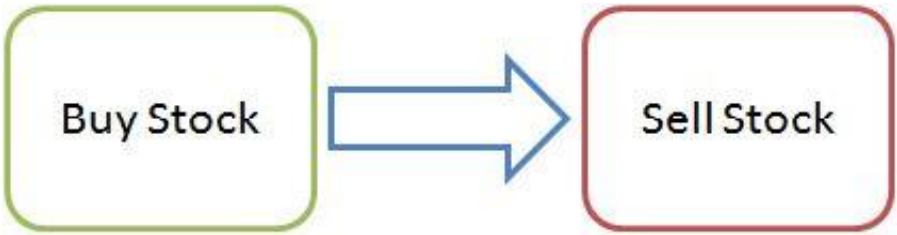
This second spike is indicative of true fear coming into the markets. This is the "blood" we were looking for. From here, it's often a good spot to go shopping for stocks that you've been wanting to pick up for a while but wanted to wait for a good entry point.

Setup Warnings

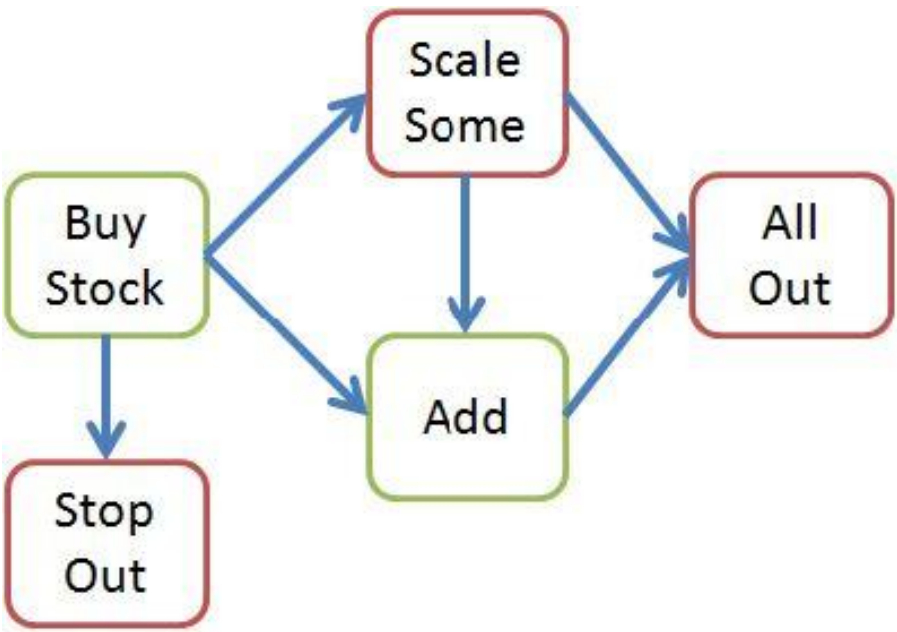
Just remember, that these setups are not always perfect and won't guarantee success in your trading. You must figure out your risk tolerance and build systems that are right for your trading style.

A Covered Call Lifecycle Map

Imagine that you want to buy a stock, then sell it for a profit. Your stock investment lifecycle would look something like this:



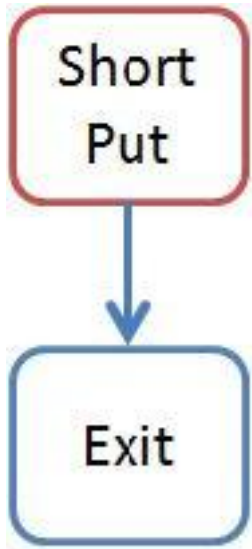
Pretty simple, right? If you want to get more active about it, a proper lifecycle map would look like this:



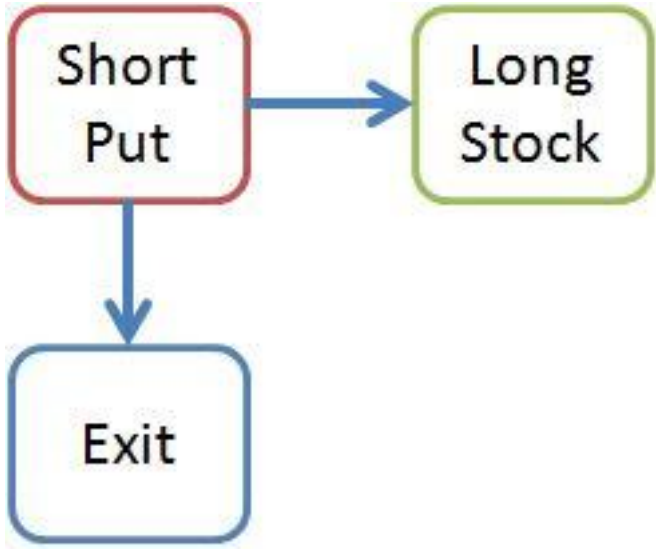
When it comes to options trading it gets a little more complicated because we are dealing with more than just stock, we have to include options that are much more dynamic in terms of directional exposure. You will also have to deal with potential assignment issues since you are short options.

In order to fully grasp the process, let's build out the entire lifecycle map from scratch. First, we begin with opening a cash-secured put sale.

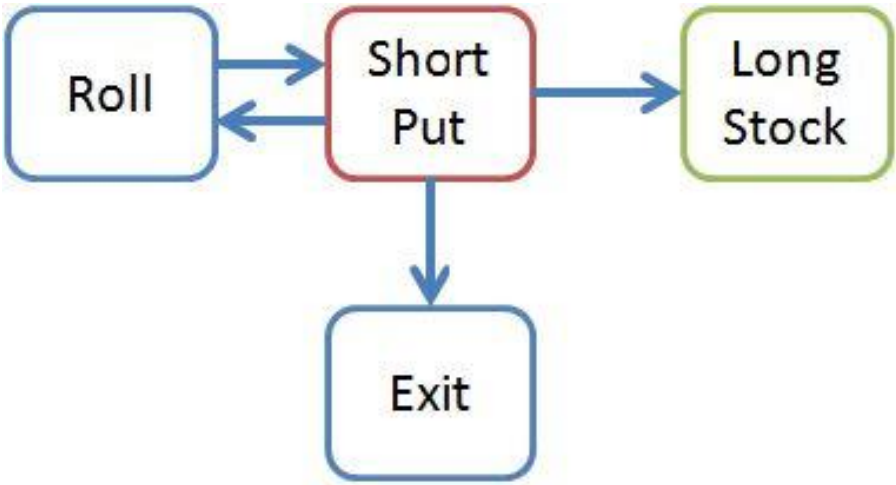
Now there are a few outcomes to consider from this trade. We could close the trade out entirely, or it could expire worthless:



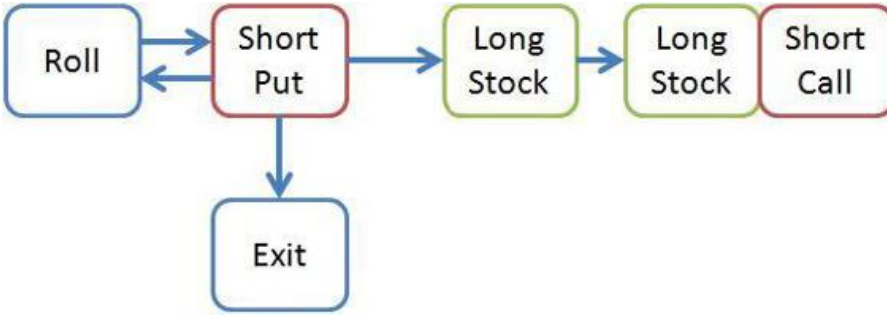
You could also get assigned. When you are short a put, you have the obligation to buy stock. So if you are assigned, then you will end up with long stock.



And you could also adjust the trade by rolling the short put to a new contract that is lower in price or further out in time. This leads you to still have a short put.



If we end up with long stock, we can then sell a call against it and further reduce our basis:

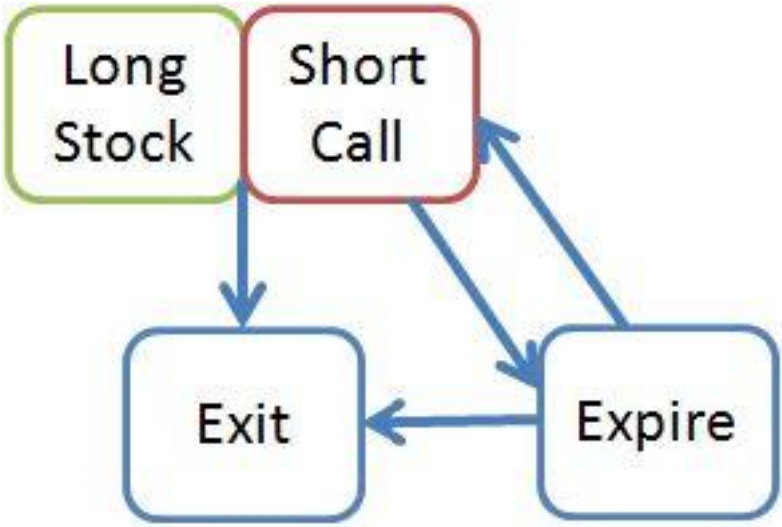


Now from here we are only going to look at the covered call lifecycle. Assuming our stock position stays constant, we only have to worry about the short call.

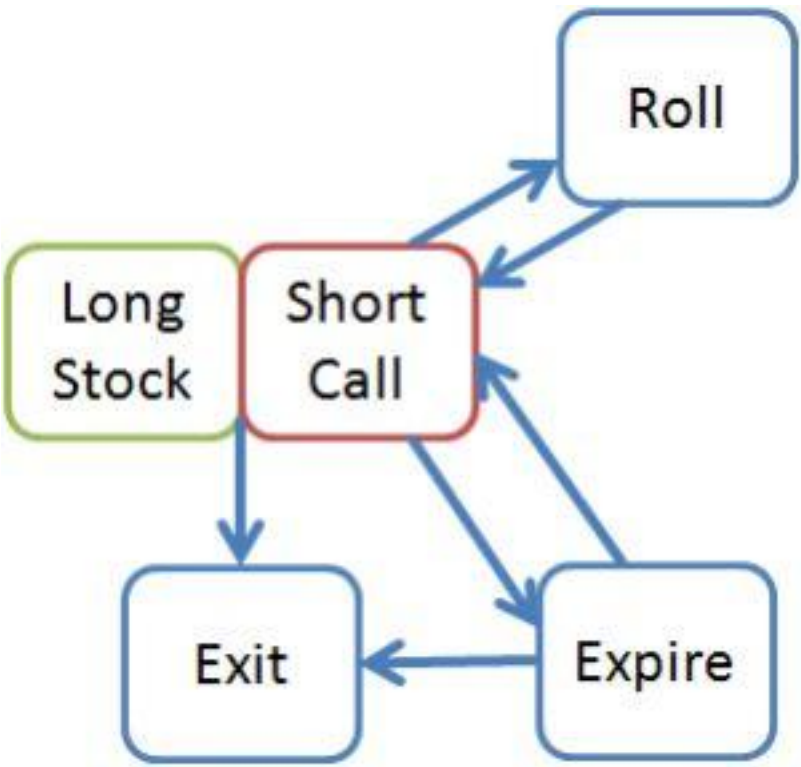
So what are the possibilities for our short call?

Well, we can get assigned on our short call position. This is known as getting "called away," and it just causes you to exit the position.

You can also have the short call expire worthless, and then you can decide to exit the trade, keep just long stock, or cover up with another call.



You could also take your pre-existing short call and "roll" it to a longer duration call.



So from here we have a pretty detailed map of all the possibilities and permutations that are available during the lifecycle of a covered call.

This may seem overwhelming, but remember you don't have to deal with each of these possibilities at once-- you just need to know where you are on the map and what the next available step is.

From this map we can develop conditions that would require you to move from one condition to the next. This is where it gets tricky-- if you are looking for a magic bullet you won't get one as each person has different risk characteristics, but we can layout an example decision tree that you can modify for your own purposes.

Delta Band Trading

Due to some mathematical voodoo, we know that the delta of an option is directly related to the odds that the option will expire in the money. This means we can use the delta to be consistent with our entry and adjustment techniques across different asset classes.

One of the best risk management techniques is the **roll**. This is where you close out an option position and open a similar option position, but with different strikes or months.

Rolling put sales and covered calls at key areas allows you to keep your overall directional risk low while maximizing your potential returns. There is a ton going on, but if you focus on triggers around your position's delta, it can help to take some of the emotion out of the trade.

Here is a roadmap to consider when considering a covered call strategy. This is broken into if/then statements, but if you want a more graphical representation, refer to the decision tree available in the bonus materials.

Covered Call Process Map	
For Cash Secured Put Sales	
If...	**Then...**
No Position	Sell a 40 delta put with 45-60 days to expiration
Delta > 70 and >2 weeks to expiration	Roll down to the 50 delta put sale
Delta > 70 and <2 weeks to expiration	Roll to next month's 40 delta put sale or get assigned
Delta < 20 and >2 weeks to expiration	Roll up to the 40 delta put sale
Delta <20 and <2 weeks to expiration	Roll to next month's 40 delta put sale or expire worthless
For Covered Calls	
If...	**Then...**
Delta > 80 and >2 weeks to expiration	Roll the call down to the 50 delta call
Delta > 80 and <2 weeks to expiration	Roll the call out 1 month and down to the 50 delta call
Delta < 20 and >2 weeks to expiration	Roll the call up to the 50 delta call
Delta <20 and <2 weeks to expiration	Roll the call up to next month's 50 delta call or get called away (then go to put sales again).

If you want this entire flowchart in a full color pdf, signup to get the bonuses.

TRADE EXAMPLES

We're going to go through a handful of trades that I have put out on my site IWO. This will include winners as well as hilarious losers.

We'll start with some simple ones first.

Fading Rate Risk in XOM

In August of 2013 I wrote:

Exxon Mobile has seen a significant selloff off its recent highs.

Much of the selling has to do with "rate risk." As treasury yields rise, funds go out of high-dividend yield names because if you can get the same rate of return with less risk, then you reallocate accordingly. That's why stuff like consumer staples and REITs have not done so well.

But with XOM coming into long term support, this is a good area to play some put sales.

Here's what to do:

Sell Oct 85 Puts for 1.10 or higher.

You keep the credit if XOM stays above 85 by October expiration. If you are assigned, it puts your basis at 83.90. From there you can sell a November call against it for around 1.50, which reduces your basis down to around 82.50. You'll also catch a dividend of around 0.80 next quarter, so if you include that into the basis calculation, you can end up getting a basis of 81.70. That's a great price to own XOM from.

A Post Earnings Fade in TGT

In September 2013 I wrote:

After a not-so-stellar earnings report, TGT has dropped over 12% back to levels not seen since March:

The stock has a bit of a bear flag look to it, but I think any further movement to the downside will give you a good opportunity to sell premium and get a great basis on this stock for a long term hold.

Here's the trade I like:

Sell TGT Oct 62.5 Put for 1.15 or higher

So if TGT drops under 62.50 then you get assigned with a basis of 61.35. If you can pick up a November call to sell against your stock and it puts your basis in the 60s. From there you catch a dividend and

it puts you around 59, which is a great price to own this stock.

Statistically Oversold in TLT

The short bonds trade is hilariously obvious by now. I'm sure Bill Gross is now booked solid on CNBC to talk is long bond book.

And don't get me wrong, treasuries have been hit with a ton of volatility. We've had a 30-year (40?) secular bull market in bonds, and I'm sure many still believe the risk-freeness of Treasuries.

But with that context, check out a weekly chart of ZB (bond futures) with a 20-week rolling return indicator:

[Note: This indicator is available in the Bonus materials]

The rate of change over the past 20 weeks is pretty unprecedented. And I think that you can get away with a cash-secured put sale:

Sell TLT Oct 100 Put for 1.05 or higher

You sell an Oct 100 put for about a dollar and you got a basis of 99. If assigned, you then sell an ATM call against and it puts your basis around 97.50. The etf has a monthly dividend of around .25 so you are down to around 97.25. If you do that a few more months and you've got yourself a good looking long bond position for a long-term hold.

Buying the Blood in Oil

In November 2013 I wrote:

Crude oil has been hit very hard over the past month. We're now down 10% on a rolling basis.

Given we are oversold and heading into key support in the low 90's, this is a good place to pick up some exposure in USO for a long term hold.

Here is the trade I like:

Sell Jan 33 Put @ 0.97 or higher

Basis: 32.03

Return on basis: 3%

If assigned in January, we will sell the Feb 32 call against, which will move the basis down to 31. From there we just keep selling covered calls against it until called away.

Avoiding disaster in CCJ

Cameco Corporation is a company that deals with Uranium mining. Back in 2011 the stock was nailed on the Fukishima incident, where a tsunami + earthquake + godzilla disaster caused the nuclear facility to overload.

This lead to a nasty move overnight.

But this isn't about that time. This is about a month beforehand.

On February 8th, I called out a put sale trade:

Sell Feb 40 puts @.60

Basis: 39.40

Return on basis: 1.5%

This trade is known as a pb2bo pattern, or pullback to breakout. The idea was that as it pulled into previous resistance, it will find support and rally.

Fortunately, the put expired worthless into February opex. If I had chosen to roll the trade out to March, I would have been left with this:

So I dodged a bullet. I got lucky.

But let's say I got stuck in this position, would it have been salvageable? **Let's go through a hypothetical scenario.**

It's February options expiration and I decide to roll the put out a month in time. So I would go out and sell the 41 put for 1.10.

Assuming I want to account for the profits from my original trade, this would put my theoretical basis at 38.30.

Then we see a nasty gap down to 31. I'm now at an unrealized loss of $730 per put sale.

We open up on March 14th around 32. At this point I can decide whether to add to the position, roll the put down, or close it out for a loss. Just for simplicity's sake, let's assume I just hold the short put through expiration and I end up with stock at a basis of 38.30.

At March Opex, the stock is trading at 29.40. So from here I can sell the Apr 31 call for 1.30, which puts my basis down to 37.30, and if called away I would be at a loss of $630 per covered call.

April comes around, and it doesn't look like it's getting any better:

At April opex, the call expires worthless, and I can sell the May 30 call for 0.80, which puts my basis down to 36.50. I also caught a dividend of .10, so basis is now down to 36.40. If I'm called away, I'm at a loss of $640 per spread.

Let's move to May opex-- not much has improved:

Now that the May options are worthless, I can now sell the Jun options. Because the risk from Fukishima continues to head down, the implied volatility is low which means I am not collecting as much premium anymore.

Selling the Jun 28 call for 0.70 reduces my basis to 35.70. If called away I end up at a loss of -$770.

June is not any better:

Again, the June options expire worthless, and I can roll out to July.

The Jul 25 calls are going for 0.60, which moves my basis down to 35.10. If called away, I'm looking at a loss of -$1100 per covered call.

July comes around and I am called away:

At the loss of $1,000, once you include all dividends and rolls. That sucks.

Keep in mind this was all hypothetical, and it shows you the problems with trying to play covered calls in broken stocks. It can be a very tricky endeavor.

Now in hindsight, "averaging down" may have given you fewer losses. But if you don't time it just perfectly, here's what you are left with:

Could you have finally ended up with a profit in the trade? Sure it would have just taken you 18 months to work your basis down.

What this does is **it ties up both your investing capital as well as your emotional capital**. You can't focus on the best opportunities because you're too busy managing a dog of a position. Sometimes it's best to just exit out of a busted trade.

A Failed Fade in RAX

RAX had an ugly earnings report and was coming into key support at its inclining 200 day moving average as well as price support.

So my brilliant idea would be to fade the momentum here, thinking that the nastiness from earnings would already be priced in.

Not so fast.

This was the start of a fugly downtrend, on the back of price competition across the board in the company's space.

The trade was:

Sell Jun 55 Puts for 3.00 or higher

I wrote:

> If we are assigned, we will have a basis at 52 and then we will sell some calls for around 1.50-2.00 which will move our basis further down to 50, which is a great cost basis for RAX.

Sounds like a great plan, right?

Keep in mind, that we're currently in February, so these puts are

longer dated, meaning we've got 4 months before we even deal with expiration.

Here's what happened:

Yeah, stock got cut in half.

Now this is one where I did end up averaging down, but in a very specific fashion. First, I went in with half size and intent to add, so while it wasn't a perfect risk management strategy, I still had some planned risk involved.

So I'm coming into June with a basis around 50. When assigned, the stock is trading at 35.38. So from here, I do something called a "**covered strangle**," which is simply a combination of a put sale and a covered call. I sell the Aug 40 call at 1.35 and the Aug 35 put at 2.75.

To figure out potential outcomes, let's break the trade up a bit. If the stock sells off under 35, I've got a covered call with a basis of 48.65 and then I have new stock at a basis of 32.25 (from the put sale). That puts my new basis at 40 bucks, which is a lot better of a basis to manage.

If the stock rallies, then the put sale expires worthless and I can get

called away. I then put the credit of 2.75 towards my basis in the stock. Combined with the call sale, my new basis is now 45.90, and if called away I will then sit at a loss of $590.

By doing the covered strangle I had the ability to reduce my potential losses by 50%.

RAX eventually traded back up above 50 by September. I wish I could tell you I was a market genius and somehow rolled my Aug options out to September, but I was happy to be out with a not-as-big loss.

Moral of the story: if you are playing higher-risk stocks, you may want to consider only starting with 1/2 size and plan an add if you are assigned.

YHOO: The Holy Grail

My position in YHOO turned out to be a massive winner. It was a consistent, income-generating machine and then it finally did takeoff.

On May 20th, 2011, I called this out:

Sell to open -5 Jun 15 Puts @.22

Cost basis on stock: 14.78

Return on basis: 1.5%

This was on the back of YHOO coming back and testing key support. That level did eventually break and I was assigned with a basis of 14.78.

At June expiration, I had stock with a basis of 14.78. I then took this trade:

Sell Jul 15 Calls @0.50

This would reduce my basis further to 14.28.

Then July comes around, YHOO is still trading in that range, so I roll the Jul 15 calls out to the Aug 15 calls out for a credit of 0.66. This puts the basis further to 13.62, and if I get called away I have a return of 10% on my basis.

We then get some nasty action to the downside, but by the time August opex rolls around I can roll the Aug 15 calls down and out to the Sep 14 calls for a credit of 0.40. My basis is now 13.22.

During this opex cycle, I end up dumping the calls for cheap and then end up selling the Oct 16 calls for .70. I have my basis recorded at 12.52, but I'm missing the cost of the roll from September. I will keep going with the numbers I have.

For some magical reason, YHOO continues to trade around that 14-17 range for a while. I end up selling the Nov 17 call for 0.50 and the Jan call for 1.10. I chose January because the December options did not have enough premium to justify entry.

Going into 2012 I've got a basis in the 11's for YHOO. The stock then spends the next 9 months in the same trading range:

If you could pick the "perfect" kind of covered call candidate it would be this-- something that is stuck in a big, dumb stupid range but has enough premium to sell calls against it month over month.

I head into the fall of 2012 with a basis in the 9's. This counts as a "homerun" trade when it comes to covered calls.

WRAPPING IT UP

At this point you are now fully versed in the risks, rewards, and tradeoffs of covered call trading. You know when to avoid this strategy and when to put it on. You have seen key trading systems and risk management techniques that will maximize this strategy.

If you're ready to take the next step, here are a few tips:

1. Develop a trade system. You need to know why you are getting into the stock in the first place, and that methodology should become a system if you want consistent profits. It doesn't matter if you are trading based off a company's fundamentals or some voodoo in tea leaves-- just make sure you aren't doing it "on a hunch."

2. Rope Up. Find a community of like minded traders that can help you on your journey. It's no fun to sit by yourself all day with no feedback on your trades. The right forum or chat room can be a great asset to your development.

3. Get a journal. Ah, the tip that nobody ever does. "Logging" things is tough whether you are counting calories or managing a sales team. It's hard, but you still need to do it. You'll see what is working and what isn't. You can get a covered call journal in the bonuses.

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QUESTIONS OR COMMENTS?

I'd love to hear your thoughts. Email me at steven@iwomail.com

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One Last Thing...

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Table of Contents

Covered Call Trading:
Strategies for Smart Investing Profits
By Steven Place
- How to Get the Most Out of This Book
- Why You Need to Read this Book
- 3 Beliefs That Keep You From Trading Covered Calls
  - Have a Belief In Yourself
- Table of Contents
- Introduction
- Financial Disclaimer
- What is a Covered Call?
  - Risks and Rewards
- Why Trade Covered Calls?
- The Downsides of Covered Calls
- Key Covered Call Metrics.
- Exmple Basis Calculations
- Covered Call Greeks
- The Major Tradeoffs
- A Secret Strategy
- What Plays to Avoid
- Designing Covered Call Screeners
  - A Baseline Screener
  - An Alternative List
- Some Trading Systems
- A Covered Call Lifecycle Map
  - Delta Band Trading
- Trade Examples
- Wrapping It Up
- Disclaimer
- Where The Charts Come From
- Questions or Comments?